

MCKINSEY GLOBAL INSTITUTE

A WINDOW OF OPPORTUNITY FOR EUROPE

JUNE 2015

EXECUTIVE SUMMARY



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MCKINSEY GLOBAL INSTITUTE

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A WINDOW OF OPPORTUNITY FOR EUROPE

JUNE 2015



Eric Labaye | Paris

Sven Smit | Amsterdam

Eckart Windhagen | Frankfurt

Richard Dobbs | London

Jan Mischke | Zurich

Matt Stone | London

IN BRIEF

A WINDOW OF OPPORTUNITY FOR EUROPE

Europe's growth since the start of the financial crisis has been sluggish and the continent faces some difficult long-term challenges on demographics and debt levels. But new MGI research finds that, thanks to a convergence of low oil prices, a favourable exchange rate, and quantitative easing (QE), Europe has a window of opportunity to undertake ambitious reforms, stimulate job creation and investment, and unlock new economic dynamism.¹

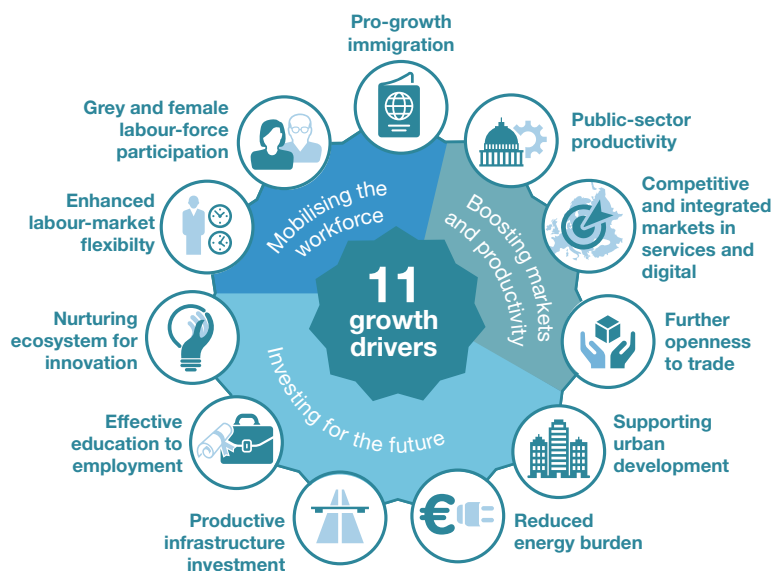
- It may be tempting for some observers to write off Europe. That would be a mistake. The continent has a foundation of strength on which to take action. It remains a world leader on key indicators of social and economic progress. And respondents polled in an MGI survey and conjoint analysis of 16,000 Europeans in eight countries had high aspirations and expressed willingness to make tough trade-offs to achieve them.
- Three areas of reform with 11 growth drivers—many of which policy makers already implement in some form—can help deliver on European aspirations. They entail investing for the future (for example, nurturing innovation and reducing the energy burden), boosting productivity (for example, competitive and integrated markets in services and digital and more openness to trade), and mobilising the workforce (for example, increasing grey and female labour-force participation and enhancing labour-market flexibility).
- Three-quarters of the impact of growth drivers can be obtained at the national level. Best practice on every key dimension of the economy can be found somewhere in Europe. The challenge is to emulate that best practice and adopt it more widely.
- Scope for structural reform is limited while investment and job creation is weak. Corporations are piling up cash despite low interest rates, households have cut investment since the bubble, and governments have adopted austerity policies. While every sector is acting rationally, collectively they are causing weak demand that means output is still 15 percent below pre-crisis trends.
- Europe has several options for reigniting investment and job creation despite its complex institutional setup. Measures to unlock financing and quantitative easing can help but are insufficient on their own. Fiscal stimulus is not easy to implement at scale in Europe. New ideas need to be explored, including accounting for public investment as assets depreciate rather than during capital formation or carefully adjusting taxation and wage structures.
- By scaling up and speeding up reform mostly at the national level and stimulating investment and job creation at the European level in lockstep, Europe could close its output gap, return to a sustained growth rate of 2 to 3 percent over the next ten years, unleash investment of €250 billion to €550 billion a year, and create more than 20 million new jobs. This requires trust and the right governance structures that avoid moral hazard, bundle tight package deals, or lift investment programmes to the European level.

¹ We define Europe in this report as the EU-28 plus Norway and Switzerland.

A window of opportunity for Europe

€2.2 trillion a year needed to meet European aspirations by 2025

Europeans seen willing to make trade-offs—e.g., more working hours and/or less social protection—for higher incomes and better education, health care, security, and living environment



Increasing competitiveness

Implementing European best practice in three key areas can deliver growth aspirations

75% can be achieved by national governments

Act within current governance structure where possible (e.g., QE)



Test potential for a post-Maastricht governance system to enable bolder action



Look at new solutions like balance sheet accounting and unleashing household spend



Reigniting investment and job creation

Action needed to kick-start growth

15% BELOW

Europe's output is well below its pre-crisis trend

Growth potential

If Europe undertakes reform on the supply side AND boosts investment and job creation—moving beyond crisis management and establishing the vision, trust, and governance to act at speed and scale—**2–3% sustained GDP growth** is possible

**2–3%
growth**



A WINDOW OF OPPORTUNITY FOR EUROPE

Several recent developments suggest that Europe has a window of opportunity in the short term to accelerate reform and stimulate job creation and investment. They include the sudden and largely unexpected drop in oil prices, a favourable euro exchange rate, the announcement by the European Central Bank (ECB) of a quantitative easing programme, and an improving business climate. All of these together point to economic growth being stronger in 2015. Now is the time to act. The next few years will determine whether Europe continues moving forward or falls back.

Sustainable growth and prosperity will likely be obtained only when far-reaching structural reforms implemented mostly at the national level are carried out in concert with stimulation of investment and job creation enabled at the European level. They are mutually reinforcing, amplify each other's impact, and are very likely to return Europe to sustained GDP growth of the 2 to 3 percent a year that can meet the aspirations of its population. Europe would then have an opportunity to unleash investment of €250 billion to €550 billion a year in innovation, education, infrastructure, and energy and, by closing its output gap and mobilising its workforce, create more than 20 million new jobs.

Not all options described in this report will be met with unanimous approval. Some of the ideas discussed involve trade-offs beyond economics and would require a new consensus. The analysis offers a sense of the pathways to a new deal for Europe rather than a precise route. It is our hope that this effort sparks an invigorated discussion across the continent on the most effective and viable path to reform.

EUROPE HAS A PLATFORM FOR AMBITIOUS RENEWAL

Europe has had a sluggish recovery and now faces debt problems as well as a challenging level of social commitments given its demographic burden. Per capita GDP in terms of purchasing power parity has only just returned to its pre-crisis peak for the continent as a whole, and the longer-term growth performance of Europe has been declining.

There is apprehension that ageing will further sap the European economy's strength and put even more pressure on governments' finances unless countries manage to turn longer healthy lives into longer economically active lives. The prime working-age population in Europe, conventionally defined as aged 15 to 64, is set to shrink by 4 percent, or 14 million people, in the period to 2030, and by 12 percent, or 42 million people, to 2050.

Given current primary fiscal balances, interest rates, and projected real GDP growth, the ratio of government debt to GDP will continue to grow from already high levels in many European countries including Belgium, Finland, France, Italy, the Netherlands, Portugal, Spain, and the United Kingdom. This is a source of concern since high debt levels have historically been a drag on growth and increased the risk of financial crises that can spark another set of deep economic recessions.¹

But Europe still has much to celebrate. Its countries include world leaders on key social and economic measures. It is one of the world's largest economies, generating 25 percent of global GDP—larger than the United States. Europe is home to a huge, highly integrated

¹ *Debt and (not much) deleveraging*, McKinsey Global Institute, February 2015.

domestic market of 500 million inhabitants. European economies are well connected to global flows: half of the 20 most competitive economies in the world are European, according to the World Economic Forum. Despite the difficult economic environment, many companies continue to thrive and compete on a global scale—142 Fortune 500 companies are headquartered in the region, compared with 128 in the United States. And European economies remain world leaders on six dimensions of social and economic progress and perform well on indicators of economic health. And the Eurozone has made more progress than many would have deemed feasible since the crisis in rebalancing the economy, narrowing its current account deficit and building stronger institutions.

If Europe pushes forward on reform, it could sustain GDP growth that is well above current forecasts. In a scenario in which all countries were to close the gap with the region's top-quartile performers on productivity and mobilising the labour force, the growth rate could be 2.1 percent a year—or more if Europe adopts the kind of growth-enhancing reforms we discuss in this report.

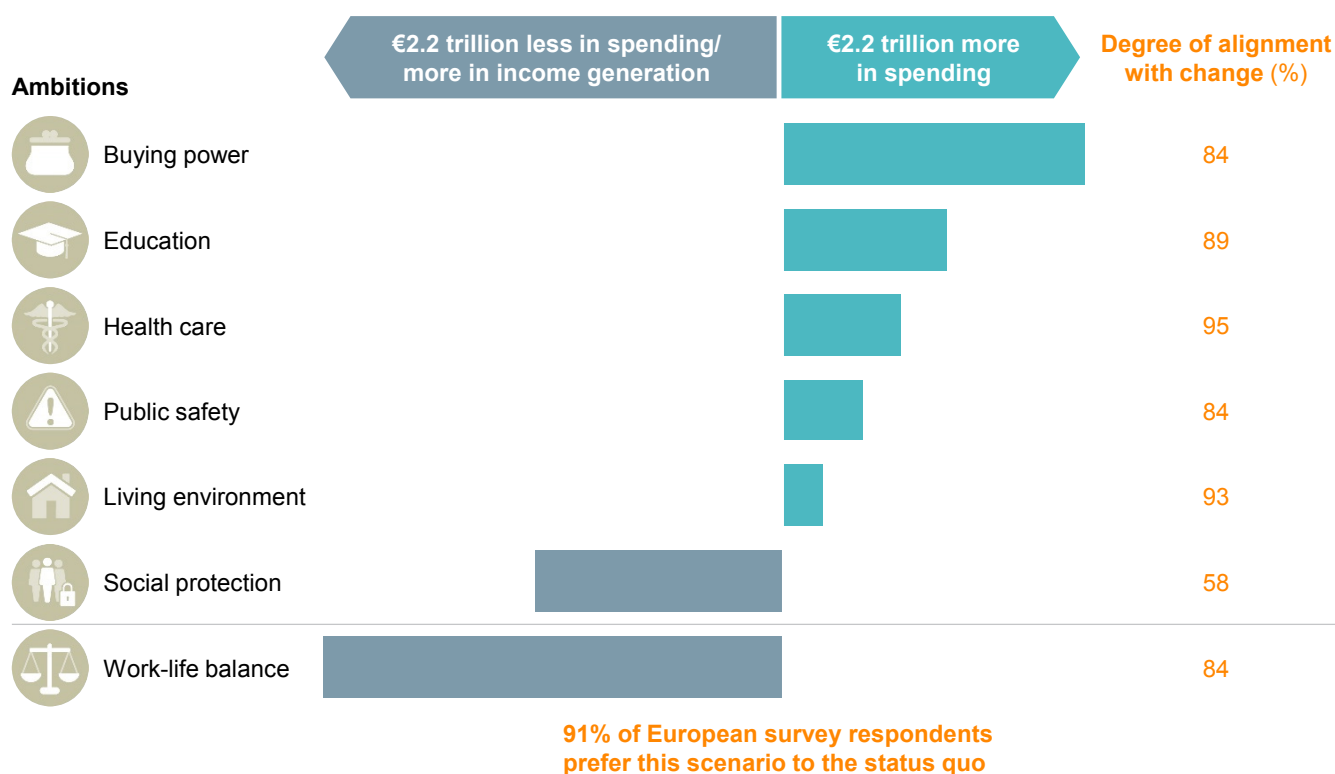
In an MGI survey and conjoint analysis of 16,000 Europeans in eight countries, respondents were asked to choose between sets of conjoint scenarios that trade off a desire to have more or less of different attributes of societal aspirations.

Respondents said they want additional investment in education, health care, public safety, and the living environment in the period to 2025, and, at the same time, increase their disposable income (Exhibit 1). MGI estimates that achieving what respondents say they

Exhibit 1

European survey respondents have high aspirations—and are willing to make tough trade-offs to achieve them

Preferred trade-off of European respondents in 8 countries¹
Additional spending and income generation (15% of Europe-30 GDP)



¹ Calculated based on Europe-30 2013 GDP and GDP-weighted conjoint scores for the eight surveyed countries.

SOURCE: MGI European Aspirations Conjoint Survey, August 2014; McKinsey Global Institute analysis

want would cost an estimated €2.2 trillion a year by 2025, or the equivalent of 15 percent of Europe's GDP. Collectively, respondents said that they would be prepared to make trade-offs to generate this amount. This preparedness is expressed as a willingness to work longer—1.8 additional weekly hours per worker on average (0.5 hours to 2.7 hours depending on the country)—and more productively, as well as a willingness to accept some reallocation of resources away from social-protection programmes. (Full details of the methodology of the survey are available in the appendix of the Detailed Analysis paper that accompanies this report.)

To deliver on citizens' aspirations in a smarter way than having them work longer or harder, European leaders must collaboratively develop a comprehensive programme of reform largely at the national level—together with investment and job creation enabled by pan-European action. Only this combination, pursued in lockstep, will overcome inertia and get Europe's growth engine motoring again.

REFORM—THREE-QUARTERS ACHIEVABLE AT THE NATIONAL LEVEL—CAN DELIVER ON GROWTH

Three broad structural reform efforts—investing for the future, boosting productivity, and mobilising the workforce—composed of 11 growth drivers could enhance the competitiveness of the European economy (Exhibit 2). Collectively, they could help the region attain an annual GDP-growth rate of 2 to 3 percent and sustain it to 2025 even as the factors boosting growth in 2015 ebb away. Most of the impact from the growth drivers comes from productivity increases, and only one-quarter comes from increased labour-force participation rates and immigration.

It is notable that three-quarters of the impact from the growth drivers can be delivered at the national level without the need for complex Europe-wide agreement and alignment. Some European countries are typically already leading on each of the growth drivers.

The other one-quarter of the collective impact of these growth drivers will require some involvement from the EU and coordinated action at the supranational level, doubling down and expanding on on-going initiatives. For instance, the EU can spur innovation in sectors with significant economies of scale by setting Europe-wide standards for disruptive technologies and open data. It also can accelerate progress in interconnecting gas and electricity networks across Europe's internal borders. The EU is also responsible for Single Market legislation and external trade agreements, and it can consolidate some public procurement at the European level to boost efficiency of spending.

Exhibit 2

Eleven growth drivers—about three-quarters achievable at the national level—can deliver on European aspirations



Incremental 2025 GDP
€ billion (constant 2014)

■ National-level catching up to leading practice

■ Leveraging European scale



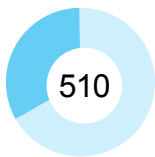
Enabler

Changing incentive structures and taxation

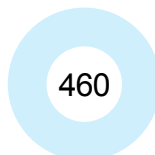
Investing for the future



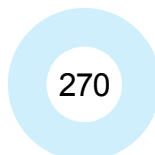
Nurturing ecosystem for innovation



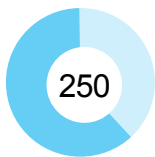
Effective education to employment



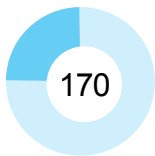
Productive infrastructure investment



Reduced energy burden



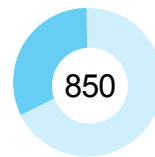
Supporting urban development



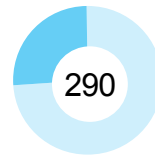
Boosting productivity



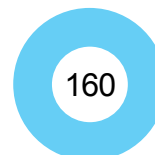
Competitive and integrated markets in services and digital



Public-sector productivity



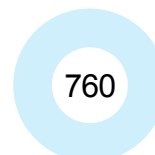
Further openness to trade



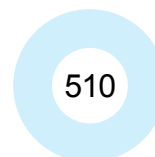
Mobilising the workforce



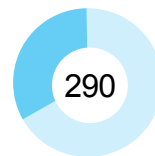
Grey and female labour-force participation



Pro-growth immigration



Enhanced labour-market flexibility



SOURCE: McKinsey Global Institute analysis

Investing for the future

There are opportunities to prepare for the future and accelerate growth in five areas of reform and investment.

Nurturing ecosystem for innovation. Europe spends only 2 percent of GDP on research and development (R&D), just ahead of China, at 1.9 percent. In particular, Europe's private-sector R&D spending—at just 1.3 percent of GDP—lags behind that of South Korea (2.7 percent), Japan (2.6 percent), and the United States (1.8 percent). Analysing company-level R&D spending, we find that Europe's gap is concentrated solely in electronics, software, and Internet services. One of the more tangible ways Europe can encourage innovation is by using government procurement. European governments spend more than 5 percent of GDP on procurement, compared with only 0.7 percent on public R&D and 0.1 percent on subsidies for private-sector R&D.

Effective education to employment. Youth unemployment has soared, hitting hardest those without a tertiary or vocational education. More needs to be done to prepare young people for the jobs companies need to fill. Some European countries have already defined leading practices in improving pathways from education to employment through increased transparency about what skills are needed and jobs are available, dual-apprenticeship models, improved selection and training of teachers, measurement and evaluation of schools, and putting in place forums to facilitate dialogue between employers and educators.

Productive infrastructure investment. We estimate that European investment in transport, power, water, and telecommunications infrastructure over the past decade has been 0.3 to 0.9 percent of GDP lower than needed to support the growth rates to which Europeans aspire.² The rate of investment needs to be optimised—which in most cases implies an increase—and alternative funding options outside the tax budget should be explored. But there is also at least as large an opportunity to spend more productively. MGI research has shown that countries could save as much as 40 percent on their infrastructure bills if they applied global best practices on project selection, delivery, asset management, governance, and finance.

Reduced energy burden. Electricity and natural gas prices for European households are now around double those of the United States. The broad imperative is to use energy more productively and efficiently. Today, there is huge variation in the energy intensity of the household, transport, industry, and service sectors across Europe. Laggards can be five times as energy-intensive as leaders. In parallel, Europe should lower energy costs by fully integrating electricity and gas networks and markets and by establishing a pan-European framework for increasing the supply of new energy sources, including renewables and unconventional hydrocarbons.

Supporting urban development. Only 61 percent of Europe's population lives in a city, compared with 65 percent in Canada, 81 percent in the United States, and 87 percent in South Korea. Within Europe, there is a difference of 30 percentage points between the most urbanised region (Continental Europe) and the least urbanised (Central and Eastern Europe).³ While citizens should be free to choose where they want to live, barriers to rural-to-urban migration should be removed. These include high levels of support per capita in rural areas through the Common Agricultural Policy and national transfer schemes, high housing costs in cities, and low satisfaction with urban infrastructure. Europe can more broadly apply funding approaches such as property-value capture, as Spain has done, to support urban redevelopment.

² For details of our methodology, see *Infrastructure productivity: How to save \$1 trillion a year*, McKinsey Global Institute and the McKinsey Infrastructure Practice, January 2013.

³ MGI Cityscope database.

Boosting productivity

Three growth drivers could have a particularly strong positive impact on productivity growth:

Competitive and integrated markets in services and digital. Accelerating productivity growth in the services sector could close much of Europe's productivity-growth gap with the United States. Streamlining product-market regulation in retail, construction, hospitality, and other largely non-tradable sectors is a key avenue for growth. An equally important lever for enhancing competitiveness and productivity is further integrating markets through Europe's Single Market legislation. In transport, there is scope to push the concept of a single European sky and to increase cross-border connectivity and competition in rail as well as road haulage. Europe would also benefit from an integrated pan-European digital market.

Public-sector productivity. The public sector in Europe accounts for 26 percent of the continent's GDP, with public transfers comprising an additional 22 percent of GDP. Governments could improve public-sector productivity by redoubling efforts to improve its measurement, creating competitive conditions in the provision of services where possible (including through the judicious use of outsourcing), and increasing transparency and tracking performance to reinforce accountability internally and vis-à-vis citizens. Joint purchasing and pooling of resources at the European level—in defence, for instance—could also substantially reduce costs.

Further openness to trade. Europe is the world's largest exporting region. Excluding intra-European trade flows, the EU's share in global flows in goods and commercial services was 13 percent in 2012, higher than the share of China, Japan, or the United States. The rising prominence of emerging markets in global trade is a formidable opportunity for European businesses to grow and for consumers to access less expensive labour-intensive goods and services. Europe could agree to robust trade agreements with the expected growth engines of China, India, and the United States. It also could further expand an already efficient trade logistics ecosystem, and set up trade support networks similar to Germany's chambers of commerce in export destination countries.

Mobilising the workforce

Ageing can erode the available labour pool, and therefore three growth drivers designed to mobilise workers will grow in importance.

Grey and female labour-force participation. Participation in the European labour force by women aged 25 to 54 has increased from less than 50 percent four decades ago to 79 percent today, higher than the 74 percent in the United States. But there is scope for some countries to do more. Social support through harmonised maternity and paternity leave, child-care provision, and equal treatment in the tax system can boost female participation. There is also an opportunity to boost participation among older, or “grey”, workers in Europe as a whole. Life expectancy has increased by more than nine years since 1970, but the average effective male retirement age has fallen by six years over the same period. Approaches to boost grey participation include the removal of incentives not to work by, for instance, eliminating the statutory retirement age as the United Kingdom has done, and the expansion of lifelong learning and retraining opportunities.

Pro-growth immigration. Immigration can drive growth by expanding the workforce, increase demand and investment as more people need housing or local services, contribute to more sustainable debt levels as debt is carried on more shoulders, and reduce some of the pressure from ageing because immigrants tend to be younger and within prime working ages. If Europe boosted its net extra-European migration rate from 2.6 people per 1,000 inhabitants per year to 4.9 people, it could compensate for the projected 11 million drop in the working-age population, as conventionally defined, to 2025. To achieve higher immigration of people with needed skills across Europe, countries could introduce open and transparent immigration systems contingent on employment (as Sweden has done), use shortage lists (as Germany does), set up welcome centres abroad to attract skilled immigrants, and create a pan-European immigration portal, while enhancing education and integration of newcomers.

Enhanced labour-market flexibility. The share of people of working age employed in Europe was 64 percent in 2013, below the average of Organisation for Economic Co-operation and Development (OECD) advanced economies. Forty-three percent of young Europeans aged 15 to 24 are on temporary contracts. Labour mobility among European countries is only one-fourth to one-sixth of the mobility between, for instance, German Länder or between US states. Yet a number of European economies have successfully reformed their labour markets over the past decade and, as a result, reduced unemployment or increased the employed share of people of working age in other ways. Initiatives to drive impact might include a reduction in employment protection, where it seems excessive, as well as in labour taxes to incentivise hiring, particularly in the case of younger workers (Spain used both levers in its labour-market reform), adopting more assertive active labour-market policies at the expense of passive benefits (as in Denmark's "flexicurity" model), or making wage-bargaining mechanisms more flexible.

EUROPE CAN REIGNITE INVESTMENT AND JOB CREATION IN SEVERAL WAYS

We estimate that the growth drivers that invest for the future require additional spending of between 1.7 percent and 3.7 percent of European GDP for higher infrastructure investments, more R&D, better education, and quality affordable housing in growing cities. The growth drivers that relate to boosting productivity involve difficult transitions as economies rebalance and companies and public organisations restructure. The third type of growth driver—those that mobilise the workforce—will also be difficult while slack persists in the economy and unemployment remains stubbornly high.

Depressed demand in Europe has resulted in an output gap that the European Commission, the International Monetary Fund (IMF), and the OECD estimate is between 2.4 percent and 2.7 percent of GDP compared with current potential output. Output is still 15 percent below where it would have been if pre-crisis trends had continued.

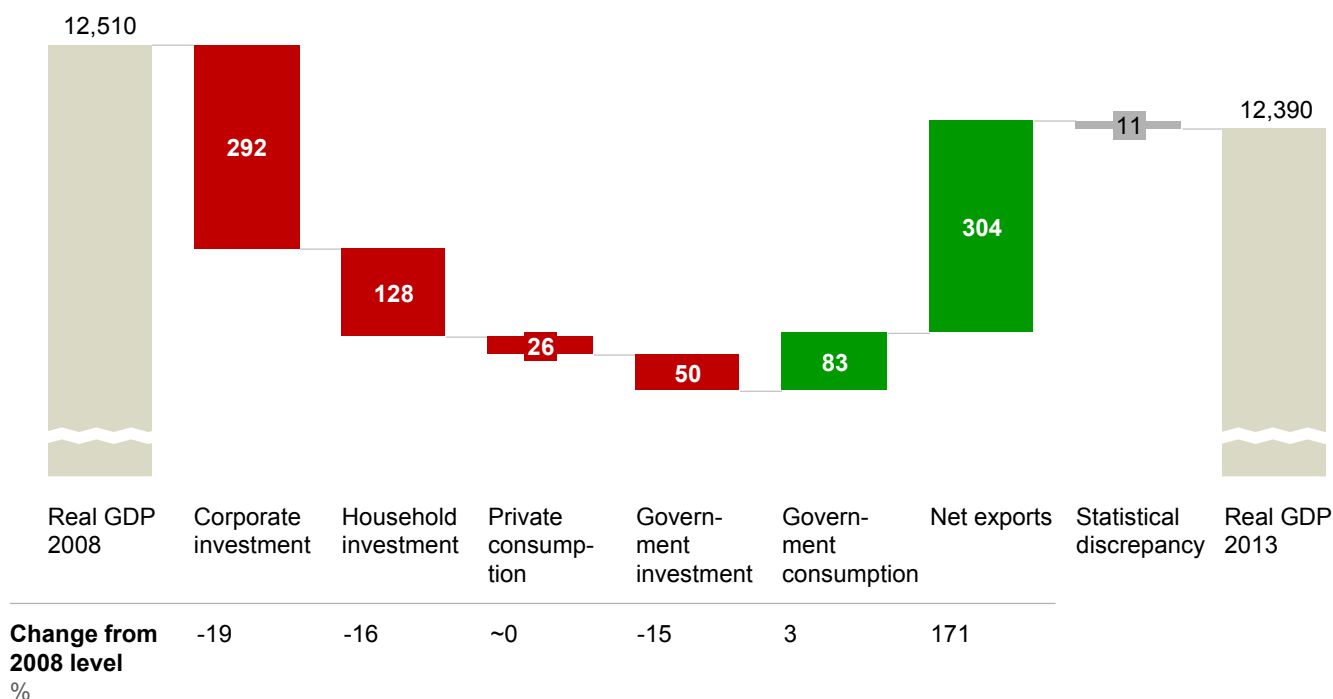
In an often turbulent global economy, Europe thus far has relied solely on exports to drive the recovery. Other sources of demand remain anaemic. Households are attempting to deleverage, companies are piling up cash because they perceive the macroeconomic outlook to be so uncertain, and the public sector is engaged in austerity programmes to keep debt levels under control. While each sector is acting rationally, the collective result is insufficient investment and job creation (Exhibit 3).

Exhibit 3

Europe has thus far relied solely on exports to drive its recovery despite a weak global economy

Europe-30 change in real GDP, 2008–13

€ billion, chain-linked volumes, reference year 2005 (at 2005 exchange rates)



1 No split of investment (gross capital formation) by source in Eurostat; government/household/corporate split from European Commission AMECO database applied to Eurostat total investment figures.

NOTE: Numbers may not sum due to rounding.

SOURCE: Eurostat; AMECO database; McKinsey Global Institute analysis

In the Eurozone, the traditional prescription of fiscal stimulus and debt relief cannot be easily replicated

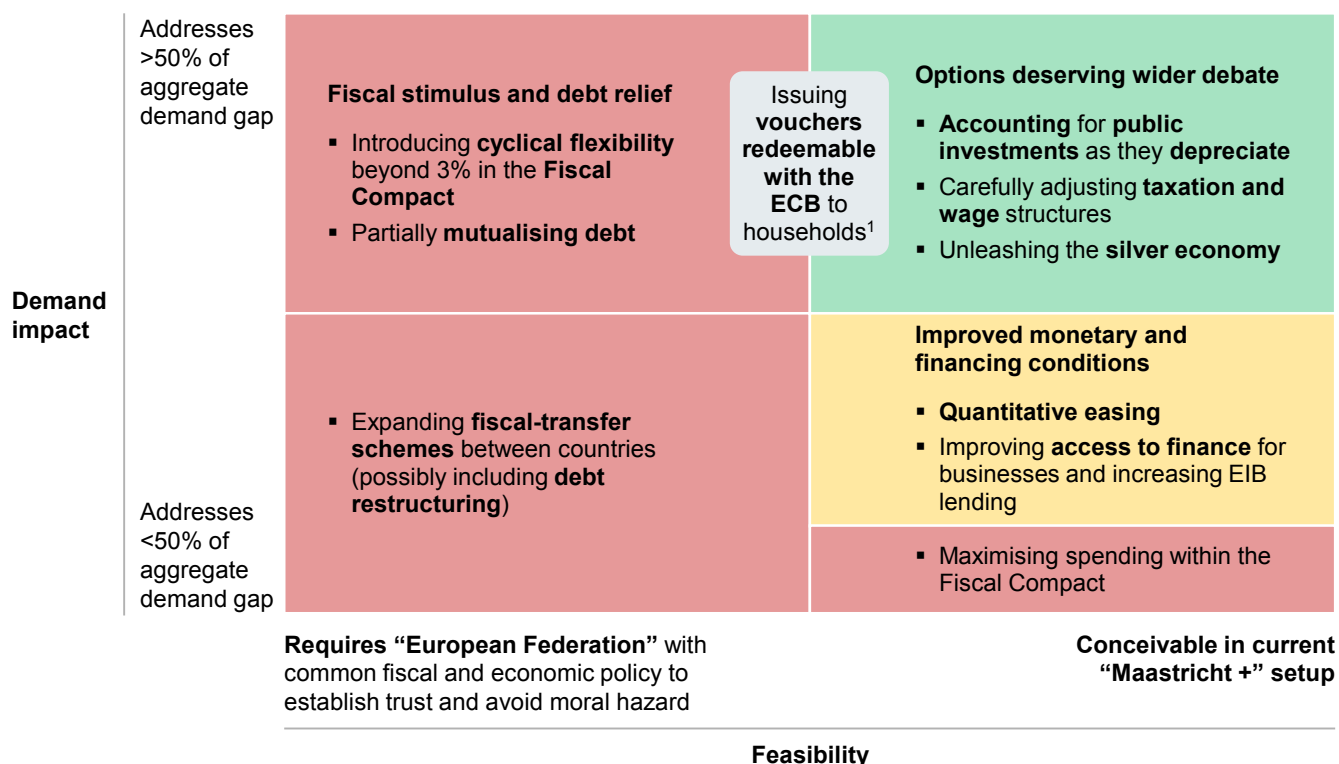
Europe has a menu of options at its disposal for shoring up demand from corporations, the public sector, and households (Exhibit 4). All options for stimulating investment and job creation entail risk and may have possibly unintended, often distributional, consequences that require careful consideration. Nevertheless, relying solely on a further increase of net exports as the way to close Europe's demand gap is also risky—at best.

Independent fiscal regimes in a currency union require either stringent rules to control deficits or credible no-bail-out commitments to avoid requiring some countries to pay the bill for high deficits in another country. While the Maastricht treaty contains both elements, the crisis has demonstrated that neither was strong enough. Government leaders took bold action and agreed on the Fiscal Compact. While this compact has been criticised for compounding the shortage in aggregate demand, it was a step towards a stronger long-term Eurozone framework and helped enable bolder central-bank action.

Exhibit 4

A menu of investment and job creation options can complement structural reform even outside a federal setup

Prerequisites for all options: Progress on competitiveness and growth drivers and structural reform



¹ Debate over whether this option would constitute hidden fiscal policy.

NOTE: There is a neoclassical school of thought that argues that structural reform is enough; however, our analyses clearly indicate a structural weakness in demand across all sectors of the economy in line with the balance sheet recession or liquidity trap schools of thought.

SOURCE: McKinsey Global Institute analysis

The traditional prescription of fiscal stimulus cannot be easily replicated in Europe. Its impact would either be too small without further measures or politically unviable without moving to an integrated economic and fiscal policy in Europe:

- **Maximising spending within the Fiscal Compact** would allow around €50 billion of additional annual fiscal expenditure, almost €40 billion of which would come from the German government. However, Germany does not have a significant output gap, and the impact of that spending on Southern European economies facing the largest shortages in demand is unclear given that their exports to Germany account for only 2.4 percent of Southern European GDP.
- **Introducing cyclical flexibility within the Fiscal Compact** would help but is hardly conceivable in the current Eurozone setup. If Europe implemented a one-time fiscal impulse of 2.2 percent of GDP, the impact on the size of the output gap would be in the order of €440 billion including fiscal multipliers.
- **Partially mutualising debt** to support further borrowing in the economies facing the most challenging conditions would require strong governance and significantly greater economic and fiscal integration to avoid moral hazard.

- **Expanding fiscal transfer schemes between countries** to close the output gap has been rightly ruled out unless the Eurozone turns into a full federation. It is notable that Europe lacks EU-wide unemployment insurance, EU-wide defence spending, and European-level tax income. A pan-European unemployment scheme could stimulate investment and job creation by €40 billion to €60 billion a year via the higher demand multipliers in countries with high output gaps compared with those operating at capacity.

Improved monetary and financing conditions will help but may prove insufficient on their own

The evidence suggests that accommodative monetary policy—traditional or non-traditional—is beneficial to the European economy during a period of stagnation, but that, by itself, cannot fully resolve Europe’s shortage of investment and job creation.

- **QE**, the purchase of securities in the open market against central-bank reserves, has several transmission channels to the real economy—many of which seem more muted in the Eurozone than they were in the United States. First, QE can resolve a liquidity crisis, but liquidity in Europe has largely been restored, and credit is constrained only in pockets of the economy. Second, QE can enable higher fiscal spending. Indeed, it does enable some flexibility via the central bank’s profit remittances back to governments on those securities held by the ECB, but despite record-low interest rates, Eurozone governments are cutting expenditure and borrowing to move towards compliance with the Fiscal Compact. Third, QE may support household spending by lowering interest expenditure and shoring up asset prices. But with Europeans’ affinity to bank deposits, higher asset prices would affect those in the population with the lowest propensity to spend, and lower interest rates would also be reflected in bank deposit rates. Fourth, in the corporate sector, interest rate reductions do not seem to be an important factor in corporate investment decisions as hurdle rates are rarely adjusted and the demand outlook remains weak. Finally, QE may help lower the exchange rate of the euro and support net exports. In the absence of complementary fiscal measures, the jury is out on the effect of the QE programme announced by the ECB in January 2015. And keeping long-term interest rates low can have devastating effects on pension funds and life insurance companies, as well as significant distributional consequences.
- **Improved access to financing for companies** could have a significant impact, but it is unlikely to be on the scale needed to close the aggregate demand gap. We estimate that such improved access could add between €6 billion and €23 billion to demand if all SMEs were able to access financing with the same ease as those in Germany. Tools might include a faster clean-up of bank balance sheets, completing a banking union and launching a capital markets union, freeing up bank capital for lending via securitisation, preferential regulatory treatment of SME lending, and developing non-bank sources of funding, such as venture capital and private placements. I

New options should be debated to widen the range of potential solutions

The debate on measures to stimulate investment and job creation—focused on QE and the appropriate degree of retrenchment in countries’ budget deficits—has become stale. New ideas that open up new possibilities deserve more debate:

- **Accounting for public investments as they depreciate**, rather than during capital formation, is one option worth exploring. Public net investment collapsed to a mere 0.2 percent of GDP in 2013, while real public consumption increased since the crisis. A change in public-accounting standards could change the bias against investment and unlock up to €140 billion a year in productive spending while increasing the pressure to contain public consumption. Governments would need to take a balance sheet approach to accounting—as private-sector corporations do—that treats investment as assets and accounts for depreciation of these assets only over time for the annual deficit.

As with the private sector, there would need to be impairment tests for these assets to contain unproductive spending.

- **Carefully adjusting taxation and wage structures** has the potential to redirect resources to households with the greatest pent-up demand. The marginal propensity of higher-net-worth households to consume is only about one-third that of lower-wealth households, and capital income is less likely to be spent than labour income. Options include the reduction of labour tax wedges, favourable wage rounds in the Eurozone “core” countries, and judicious land, property, wealth, and capital-gains taxation. For all the current discussion about the high levels of household debt and slow deleveraging, the fact remains that the value of European households’ net financial assets is approximately 135 percent of GDP. As a first approximation, MGI estimates that a redistribution equivalent to 1 percent of GDP could trigger additional spending of around €200 billion. Policy design and great care are critical: a poorly conceived measure could indeed harm growth by promoting capital flight or a decline in investment.
- **Unleashing the “silver” economy** is another opportunity. In the Eurozone, those aged 55 and older make up only around 45 percent of households but hold almost 60 percent of household wealth. Encouraging increased spending of this demographics’ accumulated wealth could be a significant lever for boosting investment and job creation, as could be incentives for wealth transfer to younger generations.
- **Issuing vouchers to households redeemable with the ECB** could stimulate incremental spending, accelerate household deleveraging, and raise inflation closer to the ECB’s target level of 2 percent. The central bank would effectively credit households with a certain amount of money through time-limited spending vouchers, redeemable with the central bank. This would be the equivalent of printing money but would ensure that the newly minted money was used for spending in the near term. An equitable distribution of vouchers across the Eurozone would avoid the need for lengthy discussions about redistribution between countries, moral hazard, or implicit liabilities. MGI’s first-order estimate is that crediting citizens with around €650 billion, or around €5,000 per Eurozone household, through such an approach could close the demand gap in Europe. This idea is bold and is likely to have considerable impact, but it is also a risky concept. Possibly the largest potential risk is a backlash from the financial markets and an erosion of citizens’ trust in the common currency.

EUROPE CAN OVERCOME BARRIERS TO ACTION

The stakes are high. We broadly see four possible futures for Europe, and only if the stalemate of reform vs. stimulus can be overcome is greater prosperity highly probable. A programme of investment and job creation without any structural reform could all too easily prove a “shot in the arm”, resulting in a boost to growth in the short term but possibly precipitating another financial crisis as capital markets take fright at the sustainability of some countries’ debt burdens. Meanwhile, structural reform without any investment and job creation support is likely to prove deflationary and politically risky, with high unemployment, increasing political instability, and even, potentially, the break-up of the Eurozone. Only moving in lockstep on national level reform and reigniting investment and job creation (enabled at the European level) can lead Europe out of the current gridlock and return the continent to a sustained growth rate of 2 to 3 percent a year.

Agreeing to measures to stimulate investment and job creation at the European level is difficult—as we know from the fact that debate on the best path forward has been going on for six years. Most of the barriers relate to governance and a lack of trust among European partners and a fear of creating moral hazard. However, most of these issues can be overcome within Europe's—specifically the Eurozone's—current institutional framework. Without moving to a full federal system of economic and fiscal governance, there is scope to use levers that don't cause moral hazard and to design “package” deals in which national-level supply-side reform is coupled with European action on investment and job creation.

Changes in national accounting rules, or adjustment of taxation structures, could be as viable as elevating large-scale investment programmes to the European level. Ideally, the types of investments selected would be large scale, and in the interest of all Europeans, such as in developing pan-European energy grids and production facilities, upgrading the continent's security and defence capabilities, or creating multinational R&D and education programmes.

Many decision makers may fear that reform will not find favour with voters. But the evidence suggests that perceptions of electoral risk from voters who do not support the case for reform are not always justified. First, research suggests that the probability of being re-elected is approximately the same for a reforming government as for a government that does not embark on reforms. Second, the results of the MGI survey suggest that Europeans actually want decisive action in favour of growth as long as they are assured that they reap the rewards. The vast majority of opinion in the survey did not opt for the status quo but for a combination of improved health care, living environment, buying power, education, and public safety even if it required significant trade-offs. Support for this combination is remarkably consistent across countries, ranging from 87 percent support in Germany to as high as 98 percent support in Spain.

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There is a genuine opportunity for real change, a positive narrative that builds on Europe's undoubted strengths and the aspirations of its citizens, and seizes the current window of opportunity created by the confluence of a number of positive trends observed in 2015. Now is the time for Europe's leaders to shift the focus from crisis management towards framing a broad programme of national level structural reform and investment and job creation enabled at the European level that can put Europe's economy on a healthier footing for the long term.

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